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Economic Conditions
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General Business Conditions

THE crisis in Europe, the third within eleven months to menace the Continent with the indescribable tragedy of a great war, is still in the acute stage as this Letter goes to press; and although the momentous decision between peace and war may be made before this is read, at the time of writing no one can predict with assurance what it will be. The hope of peace is kept alive by diplomatic moves which show that the steps toward war are not irrevocable. But whether these moves offer real promise of a retreat from the precipice, followed by a solution that will make an end of these crises, is still obscure. In any case, they have not cleared up the anxiety or made the suspense easier to bear, and the period of strain has already been prolonged to an extent almost without precedent.

Because of the severity of the crisis, the fact that it was generally foreseen has not saved the markets and the foreign exchanges from shock; but with few exceptions the disturbance has been surprisingly moderate. Since the crisis a year ago it has seemed probable that the war danger would reappear, and since the German move into Czecho-Slovakia last March the indications have been plain and the warnings numerous. With this notice, business men and investors both abroad and in this country have limited their outstanding risks and taken precautions in their own affairs, all valuable in easing the effects of the crisis. However, war or the menace of war is difficult to prepare for. The adjustments required are far-reaching and painful, and it is impracticable to anticipate them in detail, or to guard against all the effects. Moreover, it is natural and desirable to do a normal business as long as the situation permits.

The most important effect of the crisis has been the break in sterling exchange, due to the renewed movement of capital out of London in search of safety, and to loss of gold reducing the backing for the pound to a point where further support by the Equalization Fund at the $4.68 level was considered unwise under the conditions. While the lower pound will increase the cost of England's purchases abroad, this consideration was obviously less urgent, in the emergency, than the need to check the capital movement and conserve gold.

From the world viewpoint, the withdrawal of support from sterling creates renewed unsettlement, at least for the time being. International commodity markets are greatly affected by what goes on in London, and the fact that England's purchases have been made dearer tends to be depressing to prices, other influences being equal. Also the drop has created problems for the countries which had tied their currencies to sterling, and to which the depreciation was unwelcome; and as described later some of these currencies have been detached from the pound. In view of the emergency, and the resoluteness with which the British authorities have supported the pound to the extent of losing well over a billion and a half dollars of gold in something more than a year, their action cannot be interpreted as a violation of the Tri-Partite Agreement.

In the security markets trading has been orderly, liquidation light, and prices have shown marked rallying power as the market view turned from despair to hope. Nevertheless, both bonds and stocks have lost ground during the month. The moves by investors toward liquidity have a counterpart in business, in conservative buying policies and a natural unwillingness to go ahead with new plans until the situation is clearer; but trade and production figures thus far show no appreciable effect. The commodity markets have been firm, which is reassuring as to domestic conditions.

Effects of European Situation on U. S.

The Munich crisis found business men uncertain as to the possible effects of war upon this country, but for months past the possibilities have had to be studied and considered in all business calculations. On the unfavorable side is the general truth that war is the most disrupting influence upon the world economic organization that can possibly be experienced,

and non-combatants as well as combatants are affected. War ruthlessly disorganizes the co-operative system of production and trade. It takes men from the work of supplying each other's wants, and sets them instead to waste and destruction. It interferes with transportation, creates new credit hazards, closes some markets and opens others, and raises the demand for some goods and reduces it for others. It raises costs and throws prices into disorder, and thus upsets the accustomed terms upon which trade is carried on. On the financial side, the simultaneous increase in demand for goods and the withdrawal of workers from productive activity, together with expansion of credit to finance Government expenditures, subjects every country to the danger of inflation. War upsets established currency relationships, as already shown, and it adds to debt, wastes capital and savings, and breaks down monetary systems. All this requires no demonstration to the business men of today, for the last war was part of the experience of most of them, and all have lived through the great depression which was the aftermath of war. Of course the United States would have to make adjustments to these changes if war should come.

On the other hand, there are many reasons for thinking that the transition to war conditions would take place in more orderly fashion than in 1914. The outbreak then found business unprepared and the shock was stunning in its effect. Foreigners had large American security holdings and balances in this country subject to withdrawal, the dollar was weak due to an unfavorable balance of current payments, and the amount of gold available to support the dollar was small. Europeans wanted their money home, and their effort was to turn their American securities into cash and convert their balances into sterling and other currencies. This resulted in liquidation which forced the closing of the Stock and other Exchanges; and the heavy payments to be made abroad caused temporarily a sharp decline in the dollar. Meantime our foreign trade was disrupted and many commodity markets weakened. Business had already been in a downtrend, and it experienced a further sharp setback from which it did not recover until 1915.

Differences From 1914

At present also Europeans have large security holdings and short term balances here, estimated by the Treasury at $2,700,000,000 and $1,700,000,000, respectively. However, the total of these funds is less than the excess reserves of the banking system, which aggregate $4,740,000,000; and payment of any conceivable demands could be made without credit stringency, even without resorting to other measures available to cushion the withdrawals. As for the dollar, it is buttressed by more than $16,600,000,000 of gold, a sum fantastically in excess of any requirements.

Moreover, the security markets stand in no such fear of liquidation. In the present crisis the British Government acted promptly to control sales of foreign securities by British people, and this doubtless is a preliminary to sequestration of such securities if events should make it advisable, for the purpose of mobilizing foreign exchange with which to support the pound and pay for purchases of foreign goods. Obviously liquidation under this procedure would be orderly, while the equivalent purchases of industrial goods would create buying power tending to support stock prices against the liquidation. Likewise the experience in cooperation among the governments in recent years, as through the Tri-Partite Agreement, could be availed of to keep the situation in order.

These are reasons for thinking that the financial disturbance of an outbreak of war would be in no degree comparable to that of 1914. As to the commercial disturbance there can be less assurance, but the preparations made for the shock will cushion it if it comes, and the supporting elements are to be considered.

Business Able to Withstand Shock

Naturally the effect of a shock upon business depends partly upon the condition of business at the moment. The Munich crisis caused a violent disturbance, but the trend here was strongly upward at the time, and in both trade and the markets the recovery was spectacular. Before the German move into Czecho-Slovakia in March the upswing had flattened out, and the effects of that crisis were depressing for a longer time. Since the middle of May, however, business has been in another forward movement, with the Federal Reserve index of industrial production gaining ten points between May and July, from 92 to 102 (1923-25=100).

Most observers have expected this upward trend to continue for a time. In August production has been well maintained everywhere except in the oil industry, and in some lines further gains have been made. The steel industry has continued to improve, with operations rising above the peak of last November; and they are likely to hold the peak for a longer period this year. Automobile requirements will provide the backlog of Fall steel business but orders have been well diversified.

Automobile operations have made their low of the changeover period during August, and have turned upward again; regardless of the foreign situation the automobile factories will be busy during the Fall stocking their dealers with new models. Since assemblies are starting earlier, more cars will be turned out this

Fall than last, and the requirements for materials will give support to many industries.

New orders for machine tools have been at the highest levels in two years. Textile operations have slackened less than usual during the Summer. The prospect for maintaining coal production is favorable, as consumers' stocks have not been fully replenished since last Spring's strike. Railway car loadings have made the usual seasonal increase or a little better, and one of the noteworthy developments of the month was the setting of an all-time record high for electric power consumption in the week ended August 19th.

In a few markets which were unusually active in July, including the non-ferrous metals and cotton textiles, new buying has slowed down, but producers have the unfilled orders to go on; and for the most part production, shipments and consumption of industrial goods are well in line, which makes the situation appear orderly and stable. Available figures indicate that manufacturers' inventories were still declining through June at least, and there is nothing to show any considerable building up since. Purchasing agents still think thirty to sixty days' requirements enough to have on order, some "war" commodities excepted. Retailers and wholesalers have kept stocks down and commitments moderate. Retail trade in many areas has shown improvement; the heavy gains of mail order sales over last year have been maintained, and department store sales so far reported for August make a better than seasonal gain over July.

In estimating the effects of the developments abroad, the conservatism that has prevailed is probably the most important consideration. It signifies that business will be able to withstand disturbance, and is likewise favorable with respect to the Fall industrial outlook, if the crisis passes.

Low Farm Prices

One aspect of the situation which has disturbed business observers is the low price of farm products, notably the grains, hogs and fats and oils. The outlook has been improved during August by the rally in wheat prices, and it is likely that the pessimism as to wheat was overdone, inasmuch as the Government loan, on the basis of 80c at Chicago, was always certain to help the market as more wheat began to move into the loan stock. But the hog supply for the coming months is admittedly of depressing size and the supply of fats and oils is above normal, with lard and cottonseed oil both selling recently at the lowest prices in five years. Dairy and poultry products are lower than last year.

However, the lower prices are not expected to lead to a severe decline in farm income. Estimating marketings and Government payments during the remainder of the year, the Department of Agriculture calculates that farm cash income, August to December inclusive, will probably total about $3,950,000,000 compared with $4,035,000,000 in the same period in 1938. This is a drop of only about 2 per cent. It is a mistake to think that moderate changes in farm income will dominate trade. Farmers had at least 10 per cent more to spend in the Fall of 1937 than in 1938, but business was better in the latter year.

Rejection of the Works Financing Bill

Next to the European situation, the subject of most discussion during the month has been the rejection of the Administration's Works Financing bill. The Senate passed the bill in modified form, but the House refused to consider it.

The Works Financing bill embodied what is commonly called the spending-lending program. Under the original proposals the Federal Government would have made loans for various purposes, over the next two to seven years, aggregating up to $3,060,000,000, with $870,000,000 intended to be disbursed in the fiscal year 1939-40. This was exclusive of $800,000,000 additional for the U. S. Housing Authority, which also was rejected. The advocates of these proposals have interpreted their defeat as a menace to the business prospect, on the ground that the employment which these projects would have provided will be needed to maintain buying power and trade. Some business men also are fearful of the outcome, evidently calculating that Government expenditures may be reduced more than private investment expands.

Government Spending Not Curtailed

However, the appropriations voted by the last session of Congress make it plain that there will be little if any net curtailment of Government spending during this fiscal year. Total appropriations were approximately $13,349,000,000 (including the automatic renewal of permanent appropriations) which compares with $12,118,000,000 a year earlier, and establishes a new high record for any peace-time session. This total includes items covered by special receipts, or to be spent in other fiscal years. Making these necessary allowances, the expenditures that may be disbursed within the 1939-40 fiscal year total $9,902,000,000. This compares with $9,408,000,000 estimated in the budget submitted last January. The principal additions to the budget were for agricultural parity payments, disposal of surplus commodities, river and harbor work and flood control.

If the annual appropriation toward sinking fund for debt retirement, which is made each year as provided by law but in recent years has been actually expended to only a limited extent, be excluded, the net total of expendi-

tures indicated for this year becomes $9,318,000,000. This represents an increase of $108,000,000 over net total expenditures in 1939, which amounted to $9,210,000,000.

Possibly some of the expenditures included may not be completed within the fiscal year; on the other hand, the next session of Congress may make additional appropriations. No one will be surprised if supplemental grants for relief work are called for later, and deficiency appropriations for various departments and purposes are customary toward the end of the session.

With expenditures probably greater than last year, the deficit also may be as large or larger; and since spending covered by taxes gives to one person only what is taken from another, the deficit is the better measure of the Government's net addition to the national purchasing power. Total revenue receipts for this year were estimated in the January budget at $5,669,000,000, or practically the same as actual receipts in the fiscal year just closed, which amounted to $5,668,000,000. This estimate may be carried forward without change. During July and August receipts have run about 11 per cent under the same months last year, and the estimated receipts from social security taxes will be reduced by the amendment to the law which postponed for three years the advance in old-age benefit tax rates scheduled for January 1, 1940. On the other hand, the improvement in business profits this year should increase the corporate income taxes collected in the March and June quarters of 1940.

The 1939-40 Deficit

Based on the above estimates, the net deficit (exclusive of sinking fund) this year would amount to $3,649,000,000 or $107,000,000 larger than last year, when it was $3,542,000,000. The over-all "cash deficit" (including trust fund transactions with revenue receipts and expenditures), which last year was $2,715,000,000, may be considerably larger this year, due to a number of factors, including: (a) the $107,000,000 larger book deficit; (b) loss in collections from limiting the federal unemployment compensation tax to the first $3,000 of income; (c) increased disbursements from the old-age benefit fund through liberalizing the schedule of benefits and advancing the inauguration of payments by two years to January 1, 1940; (d) increased disbursements from unemployment trust funds, as the system has recently come into full operation in every state and territory.

Despite the rejection of the Works Financing bill, therefore, Treasury disbursements may nevertheless reach the highest level in our peacetime history; and neither by comparison with previous years nor in any other sense can these operations be interpreted as "deflationary." To be sure expenditures will differ somewhat in character from those of 1938-39. There will be less money for P.W.A. and W.P.A., but more for military, naval and industrial preparedness, more for agriculture and social security, and more for the Government departments and agencies. Hence the effects of the spending may be somewhat different; there will be more business, for example, for the machinery, shipbuilding and aviation industries, which already have larger orders in hand.

A Challenge to Private Enterprise?

Some commentators express the opinion that the defeat of the Works Financing bill supplies a challenge to private enterprise to show that it can put the unemployed back to work on its own initiative. They argue that Congress has reasserted its control over fiscal policy, made a major move toward economy, and taken the most important step possible to limit the growth of Federal participation in local government and private enterprise, — all measures for business encouragement, which unquestionably is true. In the long run this may prove to be the most important aspect of the House's action. They further contend that if business drops off later, as the advocates of spending think it may, the correctness of the criticisms of private enterprise will be proved, business will have failed to meet the challenge, and necessity for the proposed spending will have been demonstrated.

However, the challenge is not as clear-cut as above stated. Much of the comment seems to assume that business is an organized body, with a group of responsible leaders holding it back or pushing it ahead, but manifestly this is incorrect. Decisions to make new investments, expand, or start new ventures, are made independently by multitudes of individuals, who rightly do not think of themselves as accepting or rejecting challenges, but are influenced by many factors, chiefly by hope of profit in their own business. Naturally they want to get ahead and do more business, and will do so whenever they judge conditions are favorable.

It is a great deal to expect that a concerted forward movement can be started by the defeat of this one proposal. We have already shown that neither total Government spending nor the Government deficit is being reduced, which means that the uncertainties aroused by the fiscal policies of the past few years cannot have been wholly allayed. Business men still distrust the record deficits, and many fear that the eventual outcome will be either boom and inflation, or a breakdown; they do not know which. Moreover, other restraints are untouched by this action. The taxes required by the spending obviously remain a charge against production, and reduce the incentive to new investment. Taxation is not only burdensome in total, but falls too heavily on profits and

makes too little allowance for losses. This discourages risk taking and also limits saving. Costs of doing business are high and unstable, and the rules which business men must follow, in dealing with labor, the Government and each other are difficult and costly to comply with. The war menace and the disturbance of trade all over the world are restraints from which no Congress can give relief.

In short, the view that business will stand condemned, if private investment fails to expand to offset the defeated lending program, overlooks the other areas in which action to promote recovery is needed. The action of the House is encouraging in itself and a promising start. The next question is whether the next Congress will keep the tight rein on spending, and also bring in a program otherwise calculated to stimulate private enterprise. Students of the problem of tapering off Government expenditures have contended from the beginning that moves in this direction must be concurrent with a broad recovery program, seeking to create an atmosphere more encouraging to enterprise.

The Crisis and the Foreign Exchanges

The European crisis brought to an end the period of comparative calm in the foreign exchange markets which had prevailed since the end of last May. Even during that period some currencies, in particular the pound sterling, which had been held steady around $4.68, had required from time to time the support of gold shipments; and during July and the first two weeks of August the monetary gold stock of this country increased by $225,000,000. An additional $230,000,000 was added to the stock under earmark, held here for safekeeping by foreign countries, which rose to the record high of $1,360,000,000.

As the new crisis developed the flight of European capital into dollars or into gold mounted rapidly. In the nine days ending August 25th the monetary gold stock increased by a further $257,000,000. Of this rise around $85,000,000 was accounted for by imports. The remainder, exclusive of a small amount of new production, represented releases from the earmarked stock. The bulk of the imports came from Great Britain or from Canada, where Great Britain has had gold under earmark, and presumably a substantial part of the withdrawals from earmark in New York was for British account.

Withdrawal of Support for the Pound

Faced with the rapidly mounting cost of the support of the pound and with the necessity of conserving the gold reserve for war emergencies, the Equalization Fund on August 25th withdrew its support and allowed the pound to seek its own level. Released from exchange controls, sterling experienced some of its widest fluctuations in years, dropping to $4.23 ($4.12 in London) and recovering to around $4.40, as will be seen from the accompanying table. The previous low for sterling since our devaluation in 1934 was $4.60, during the crisis over Czecho-Slovakia last September.

Other currencies closely associated with the pound, constituting the so-called "sterling area," also fluctuated erratically last month. The Japanese yen, the Australian, New Zealand and South African pounds and the Indian rupee have remained unchanged in terms of British exchange. On the other hand, the Scandinavian currencies, which had formerly been pegged to the pound at fixed ratios, have been cut loose from it, at least tentatively, and have advanced against the pound and maintained approximately their former relationship to the dollar and gold. In making formal announcement of this move, as relating to the Swedish krona, the Riksbank described it as part of the policy of maintaining a stable domestic price level.

If these changes prove to be lasting they will represent landmarks in the histories of these currencies. The Scandinavian currencies have been maintained at fixed relationships to the pound sterling (with occasional variations in the rate) since September, 1931, when these countries followed the lead of Great Britain in suspending gold payments. At the moment the currencies are attached neither to any other currency nor to gold, which adds another chapter to the confusion of relationships traceable to the political turmoil in Europe.

The French franc declined, staying close to its old relationship to the pound, but showed some independent strength. The belga, the guilder and the Swiss franc have remained steady, as will be seen from the table. The

Movements of Foreign Exchange, Bill Rate, Gold and Silver
(Approximate closing prices unless specified)

	Aug. 1	Aug. 24	Aug. 25	Aug. 28	Aug. 29
Currencies Still Pegged to Sterling					
£ sterling—High	468 3/16	468.125	452.00	430.00	440.00
Low	468⅛	468.06	442.00	423.00	436.00
French franc—High	2.65	2.65	2.58½	2.48	2.51½
Low	2.65	2.64 15/16	2.50	2.42½	2.48½
Indian rupee	34.99	35.01	33.75	32.25	33.00
Japanese yen	27.30	27.30	26.25	25.06	25.70
Currencies Formerly Pegged to Sterling					
Swedish krona	24.12	24.13½	24.13	24.13	24.00
Norwegian krone	23.52	23.51½	23.51	23.51	23.00
Danish krone	20.90	20.90	20.90	20.90	20.50
Finnish mark	2.06½	2.06½	2.06½	2.06½	2.06½
Others					
Canadian dollar	100.00	99 5/16	99 1/16	97 7/16	98 1/16
Dutch guilder	53.23	53.85	53.75	53.60	53.55
Belgian belga	16.99¼	16.95	17.00	16.95	16.92
Swiss franc	22.56½	22.53½	22.70	22.59	22.65
Gold Price, London	148s 6½d	148s 5d	150s 6d	161s	157s
Silver " "	16 15/16d	19 1/16d	20 1/16d	19⅛d	19⅛d
Silver Price, N. Y.	34¾	39⅝	39¾	36⅛	37
3 Mo. Bills London (%)	.68	4.00	3.84	3.85	3.91

Canadian dollar, which in the past has ranged between the pound and the dollar, declined by less than 3 per cent during the crisis.

The break in the pound was accompanied by a temporary rise of the sterling price of gold in London to 161 shillings, which is the highest price in history and represents an appreciation of 89.4 per cent over the old statutory price of about 85s. An important development following the rise was the decision of the South African Government to appropriate all proceeds, above 150s per ounce, from the sale of newly mined gold.

The price of silver, which had advanced on the war scare and on Indian speculation from 34¾ cents per ounce (New York) to 39¾ on August 25th, has since given up more than half of the gain.

Preparations for Nationalization of Foreign Assets

Prior to the unpegging of the pound sterling and passage of the Emergency Powers Bill, which conferred upon the British Government practically dictatorial powers, the London Stock Exchange Committee established minimum prices for gilt-edged securities, pegging the 2½ per cent consols at 62½ and the 3½ per cent War Loan at 88½. These prices have been maintained since. At the same time the discount rate of the Bank of England was raised from 2 to 4 per cent as a further move to deter flight of capital, and there was a concurrent rise of the three months' bill rate from ¾ of one per cent to four per cent, the highest rate since September, 1931.

In rapid succession these developments were followed by measures preparing the way for the nationalization of foreign assets in the event of war. They consisted of the prohibition of any action by private holders of certain foreign securities (including American securities) that would allow these securities to be removed from the direct control of monetary authorities, and of mandatory registration of such securities with the Bank of England. Sale in New York of American securities so registered is permitted if the dollar proceeds are exchanged for sterling at the Bank of England.

Money and Banking

In the domestic banking situation the chief effect of the crisis has been to make another huge addition, as previously described, to this country's already redundant gold stock, which on August 28th stood at $16,609,000,000. The effect of this increase in raising bank reserves has been augmented by the action of the Treasury in cashing in a portion of its remaining "free" gold, by depositing gold certificates against it in the Reserve Banks and drawing upon the credits thus obtained. On August 23rd member bank reserves were up to $10,829,000,000, an increase of $393,000,000 in four weeks, and the excess above legal requirements for the whole country reached a new high of $4,740,000,000.

The factors increasing reserves were but slightly offset by a further reduction in the Reserve Banks' holdings of Treasury bills and a continuing increase in currency payments. The Reserve Banks' bill holdings decreased for seven consecutive weeks up to August 16th by a total of $141,000,000. In the week ended the 23rd, however, the portfolio was maintained at its previous figure. The Reserve Board had stated in June, when this policy was begun, that it was "in response to technical conditions in the bill market and does not represent a change in general credit policy"; meanwhile the rate on the weekly bill offering has advanced from 0.003 per cent to 0.076 at present. The increase in currency in circulation of $96,000,000 in four weeks was greater than seasonal, as was the case during previous European crises.

Deposits and loans and investments of the reporting banks have increased steadily during the month. Commercial, industrial and agricultural loans have risen slightly, a gain in New York City offsetting declines elsewhere. As compared with the low point at the end of May, these loans are up somewhat more than $100,000,000, and evidently the increase is chiefly due to the intermediate term loans being made by the large city banks. The chief increase in investments has been in Treasury bills, Government guaranteed issues and "other" securities. With the money supply so redundant, the crisis has left short-term rates unchanged.

The Bond Market

The decline in bond prices during the crisis was substantial in many cases. The sharpest losses were in the lower-rated corporate bonds and in foreign dollar issues, but the drop in long-term U. S. Government issues amounted at one time to upward of three points, compared with the Summer highs. However, considering the severity of the crisis, the record levels which prices of high grade bonds had reached earlier in the Summer, and the substantial profits accrued to many holders which they naturally desired to cash in at the first sign of disturbance, the market has given a good account of itself. No distress selling or liquidation of consequence was apparent and prices rallied promptly whenever the international news turned for the better. At this writing they have recovered almost half their losses.

Banks as a whole have not participated to any appreciable extent in the selling; holdings of long U. S. Government bonds by the reporting member banks on the 23rd, the latest reporting date, were slightly higher than two weeks earlier, and only $14,000,000 below the

peak of July 19th. Evidently institutional holdings have been an element of stability in the market.

New security offerings were in substantial volume until checked by the market unsettlement. Among the large issues in the higher ratings that were publicly offered and met with a ready subscription were $95,000,000 Pennsylvania Power & Light Co. mortgage 3½s of 1969 and $28,500,000 debenture 4½s of 1974; also $30,000,000 Union Oil Company of California debenture 3s of 1959 and $30,000,000 Province of Quebec serial bonds. A number of large loans were placed privately with banks and insurance companies, including $30,000,000 for the Commercial Credit Co. and $25,000,000 for the Standard Oil Co. of California. A considerable number of important new offerings have been registered for issue this Fall, or are in prospect, assuming that the foreign situation permits the markets to function normally. They are chiefly public utility refunding issues, new money borrowings continuing scarce.

The National Debt

The record-breaking appropriations of the last session of Congress, referred to earlier in this Letter, and the prospect that the Federal deficit for the fiscal year 1940 may be as large as that for 1939, raise the question whether action to increase the statutory limit on the public debt will become necessary in the next Congress. The limit of direct borrowings by the Treasury is now fixed at $45,000,000,000. The direct debt at the end of the fiscal year, June 30, 1939, aggregated $40,440,000,000, leaving a borrowing margin, as of that date, of $4,560,000,000.

During the last session there was talk that the continuing deficits made an increase in the limit advisable, and the provision limiting the amount of long-term bonds within the total to $30,000,000,000 was removed at the Administration's request, to allow more flexibility in financing as between long and short term issues; but there was still ample margin for 1939-40 borrowings, and the matter of an overall increase was not pressed and not acted on. Requirements this year, however, will use up a substantial part of the remaining margin and sooner or later action will be necessary, either to raise the limit or to hold the debt within it. This may be one of the important debates of the next Congress.

Additional, fully-guaranteed, debt was $5,502,000,000, making the total of both classes $45,942,000,000. The fully-guaranteed debt consists of obligations issued by wholly-owned corporations, organized to carry on various activities on behalf of the Government. The corporations hold substantial assets as offsets to these obligations, but operate on Government credit and appropriations.

Composition of the Debt

The debt is summarized as follows, in millions of dollars:

(Direct Debt)		
Bonds—Old series and postal savings	$ 196	
" Treasury bonds	25,218	
" Savings bonds	1,868	
" Adjusted service bonds	783	$28,066
Notes—General series	7,243	
" Special series	1,983	9,226
Certificates—Special series		1,286
Bills		1,308
Total interest-bearing debt		$39,886
Matured debt on which interest has ceased		142
Debt bearing no interest		411
Total direct debt		$40,440
(Guaranteed Debt)		
Home Owners' Loan Corp.		$2,968
Federal Farm Mortgage Corp.		1,388
Reconstruction Finance Corp.		822
Commodity Credit Corp.		206
U. S. Housing Authority		115
Federal Housing Administration		3
Total fully guaranteed debt		$5,502

The debt on June 30, 1914, as carried in the public debt statement, was $1,188,000,000, but this included the non-interest bearing greenback currency and obligations upon which interest had ceased. The principal outstanding bond issues were Spanish War and Panama Canal bonds. The peak of the post-war debt was $26,597,000,000, on August 31, 1919, and at the end of the fiscal year 1930, the total stood at $16,185,000,000. The increase in the direct debt in the nine years, 1931-1939, inclusive, was thus $24,255,000,000, or if the indirect debt is added $29,757,000,000.

Notwithstanding very low interest rates on the short maturities, interest payments on the direct debt during the year ended June 30, 1939 aggregated $941,000,000. The average rate on all interest-bearing debt was 2.60 per cent.

These totals are large sums, even for the United States of America, and if the debts of the States and local governments were included the aggregate of direct government debts would be approximately $60,000,000,000. The per capita Federal direct debt on June 30, 1939 was $308.29, which compares with $12 in 1914, $240 in 1919 and $131 in 1930. The totals are so large that they have little definite meaning to readers. For the "average person" even the $308 per capita share, or $1,232 per family of four persons, scarcely excites more than an incredulous smile, but nothing is more certain than that the debt will take its toll of every man, woman and child. It will be inseparably related to every family's income and cost of living; to employment, wages and prices.

Home and Foreign Indebtedness

In discussions of the debt the point has been raised that inasmuch as nearly all is held within this country, it, practically, is "owing to ourselves," and that this is an important mitigating factor.

The reasoning seems to be that as principal and interest are payable by "ourselves to ourselves" we hold both debtor and creditor positions, which would imply that the size of the debt, and whether or not it ever is paid, are matters of small importance. No one means precisely this, but a question is raised as to just what "we," "us" and "ourselves" do mean in connection with the national debt.

Some of us hold varying amounts of the debt, but most of us have none, while all are taxed for payments on it. The statement, widely quoted, that "if our children have to pay interest on it they will be paying interest to themselves," is gravely misleading. Children or others who inherit government bonds will inherit the interest payments, but the vast majority, owning no government bonds, will inherit only the debt. The idea of "ourselves to ourselves" implies that we own the debt in common, and that payments will be made from common resources, but no such merger of interests has taken place. The United States has not been merged into a Commune. The truth is that the debt is owed *by* the nation, which means by individual taxpayers, and it is owed *to* individuals, either directly or through the insurance companies, banks and other institutions which are custodians of individual funds.

Nothing is made clearer by blurring these rights and obligations of the individual citizen, but the true situation is obscured and falsified. What happens to the individual is the matter of real importance.

The statement that the debt is payable to ourselves seems to imply that a debt payable abroad necessarily is more burdensome than a debt within our own country. But is this the matter of chief concern? Normally, the location of the creditor — whether in the debtor's neighborhood, or in a foreign country — has been a matter of convenience, or of a difference in interest charges. In earlier years millions of foreign capital were sent or brought to this country and used here for the employment of labor, building of railroads, establishment of industries and development of the country. These investments, if successful, reimbursed their owners or liquidated themselves, because they were productive and beneficial to all concerned. They enriched the country as well as their owners, and where they were owned was of minor importance.

It is true that payments across international boundaries, requiring conversion from one national currency into another, may involve complications from which payments wholly within one country are free. Examples of the "transfer problem" have been common since the Great War broke down the gold standard, caused many changes in monetary systems and disrupted long-established relations between currencies. However, the monetary changes and economic disorders of recent years have affected not only international payments, but payments among "ourselves" also. Debtors in this country have had their difficulties, and one of the main objectives of monetary and fiscal policies has been to relieve them, by cutting the gold content of the dollar, cancelling the gold clause in bonds, raising prices, and reducing interest rates. Everyone knows that the problems raised by debt are not confined to international relations. This country has seen much of debtor-creditor conflict in political movements of the past, but it was not attributable to the fact that much of our earlier debt was owed abroad.

Problems of the Debt

In considering the problem of a growing debt, the matter of chief importance is not where, or of whom, the money is borrowed, but the purposes for which the expenditures are made. During all the years that we were a "debtor country" (down to 1914) the nation was growing in wealth and productive capacity as no other nation ever had grown before. The borrowings were not burdensome, for they increased the national income and took care of themselves.

On the other hand, a debt incurred for purposes not economically productive calls for further outlays. Confusion may arise over the term "productive." It may be used in the broad sense which includes all socially useful purposes. The American people expend vast sums for socially useful purposes, in the firm belief that they are "productive" in the highest sense; but investments of this kind do not as a rule yield a direct money income, therefore do not supply the means for supporting or paying off the debt.

Obviously the general difference between debts incurred by governments and those incurred by private business is in the expectation of a money return on the investment. Most government debt is "productive" only in the indirect or broader sense, and rests on the taxing power for its support, while most private debt is intended to yield a direct income in money, by which the debt may be supported and repaid. Naturally mistakes and miscalculations are made in private investment, but the distinction is indisputable. Government debts, however socially desirable the expenditure or "investment" seems, may become an unbearable burden when people are already overtaxed.

Another matter of importance is the fact that this growing debt so largely consists of bank credit, instead of capital savings. We cannot be complacent about debt of this kind on the theory that we owe it to ourselves. The great financial and economic catastrophes have resulted from the use of bank credit for ventures that proved to be unproductive.

A slackened demand for credit for business uses has induced the banks to lend heavily to the Government, but if business demands revive, in addition to Government borrowing, a dangerous expansion of bank credit may take place. The Federal Reserve authorities have asked for power to control credit inflation. There is little danger of inflation while the attitude of the public remains as now, but the present huge supplies of idle funds as well as expanded bank credit carry potential danger not to be overlooked.

Experience of Other Countries

To sum up: If it were true that all we need to know about a debt is, that it is payable by some of us to the rest of us and in that sense payable to "ourselves," there would be no limit to the debt that we might safely create.

Every one of course recognizes that there is a limit, imposed first by the danger of inflation, and, second, by the fact that the purposes for which the borrowed funds are spent do not create the means of paying the debt.

No one in Great Britain questions that its debts for past wars are burdensome although payable to themselves. Every one in France knows that the French debt is a difficult problem, although owing to themselves. The old German debt of trillions of reichmarks was owing to the German people, but where is it now?

The International Cotton Conference

An important event of September will be the meeting of the first conference ever to be held for the purpose of exploring the possibilities of controlling world cotton production and dividing up the cotton export trade by international agreement. This conference will meet in Washington on the 5th of the month at the invitation of the U. S. Government, and will be attended by representatives of nine other cotton producing countries, namely, Brazil, Egypt, India, Mexico, Peru, Sudan, Soviet Russia, France and Great Britain, the latter two representing their colonies. Of the countries invited, only Argentina will not be represented, evidently because of her dissatisfaction with the international wheat conference, which has been meeting in London in a futile effort to reach an agreement of the same kind that is sought in cotton.

The Department of Agriculture has emphasized from the beginning that the conference will be only exploratory in character. The agenda, as stated in Associated Press despatches dated August 23rd, will consist of the following:

A presentation of the cotton situation of each country, including governmental policies relating to cotton; a review of the experience with regard to international agreements in the marketing of other agricultural products; a general discussion of the possibilities and practicabilities of international collaboration in the case of cotton; and a general discussion of advisability of calling a more formal conference to discuss such collaboration with representatives of both the cotton-exporting and cotton-importing nations.

An indication of what Secretary Wallace hopes may be realized through the projected collaboration is given by his statement at a meeting in Washington July 13th: "There is an obvious and great need for an international agreement not only assuring each exporting country its fair share of the world market but also supporting a reasonable level of world prices."

Situation Leading Up to the Conference

The situation which has led our Government to call this conference is undoubtedly known in general terms to the readers of this Letter, and the review of it may be brief. The critical factors are the extraordinary growth in the production of cotton in foreign countries during the past few years; the curtailment of the cotton export trade of this country; the accumulation of a surplus in the hands of the U. S. Government for which there seems to be no place in the world markets, now or for years to come; the increased use of synthetic fibers; and in general the tendency toward a chronic world surplus of cotton, which would be even worse but for the governmental restrictions upon the American crop.

Foreign cotton production has increased from 11,535,000 bales in 1929 to 16,075,000 in 1938, while at the same time our cotton exports were declining from 8,053,000 bales in 1928-29 to 3,327,000 during the season just ended, when they were the lowest in 60 years. The drop in exports has resulted in the accumulation of a carryover in this country on August 1, the beginning of the new crop year, of 13,032,611 bales, largest in our history, comparing with an average of around 3,200,000 during the 1920-30 decade. Of this carryover slightly more than 11,000,000 bales, almost as much as this year's prospective crop, is in the hands of the Government, accumulated through loans made to producers at above the market price.

This accumulation has occurred despite a 45 per cent reduction in our cotton acreage (average of this and last year 24,980,000 acres) from the peak, which was 45,968,000 acres in 1925. Under legislation recently passed the acreage allotment may not be set at less than 26,000.000, and the production goal at not less than 10.000,000 bales. Since this minimum acreage will normally produce more than 10,000,000 bales, and in good years a great deal more, compared with a consumption of American cotton last season of 11,265,000, prospects for disposal of the Government stock are not encouraging. Plainly an impasse has been reached from which the United States alone cannot extricate herself.

The world carryover of American cotton on August 1 was 14,150,000 bales, an all-time high,

and the carryover of foreign cottons was 7,802,000, the second largest on record. The combined carryover was 21,952,000 compared with only 13,766,000 two years earlier, and was at least double normal requirements. Another element which the conference may consider is the increase in competition which cotton is meeting from synthetic fibers everywhere, and especially in Japan, Germany and Italy.

Views of the Respective Countries

The viewpoint which will be expressed by the representatives of the United States at the conference undoubtedly will be that the existing situation is a problem of all producers, since all have contributed to it. It will doubtless be pointed out that the increase in production has taken place in other countries and not in the United States, and that all stand to suffer alike unless some collaboration can be achieved. It may be added that the action of this country in supporting the domestic price by Government loans, which has led to the distressing accumulation now in Government hands, has held an umbrella over the world cotton market. Implicit in the discussion will be the idea that this umbrella may no longer be held; and in fact it has already been abandoned to the extent of paying a government subsidy upon our cotton exports, which is notice that we are now interested not in supporting the world price, but in keeping the domestic price above it.

How strongly these arguments may weigh with foreign producers of course remains to be disclosed. Comments on the conference among foreign cotton men have been mostly adverse. The newer cotton growing countries may argue that they entered the field with their eyes open, during a time when the price was low, and that they are prepared to grow cotton on a low cost basis. They will point to the domestic employment given, the investment made in cultivating new lands, installing ginning and oil pressing machinery, etc., and the foreign exchange realized from export sales; and some can say that their alternative crops are less attractive than cotton even at low prices. Some may argue that even if it were desirable for them to limit cotton production and exports, it would be impracticable, in view of the difficulties of control with which the United States is familiar; witness the 1937 record crop here.

It would be out of order to attempt to prejudge the results of the conference, but evidently the reconciliation of the opposing views will be a formidable task. Moreover, if all producers should agree in principle to divide up the world market, would they be able to agree upon the fair share of each? In Secretary Wallace's opinion, in which the cotton trade of this country will certainly concur, the fair share of the United States is at least 6 million bales, which is 2,673,000 more than we exported in the past season. What countries will be willing to give from their share, to allow us to sell 2,673,000 bales more, in addition to putting a limit upon the further growth of their exports?

The Export Subsidy

The cotton export subsidy earnestly advocated by Secretary Wallace since early in the year, and put into effect July 27th, represents a considerable departure from the Secretary's views as expressed September 30th last year in a speech at Fort Worth. Stating then that a subsidy did not appear to be called for, he added:

> If used on a large scale and over a period of time, export subsidies employed by competing countries are mutually self-defeating. They amount to an international price war that is bound to be destructive in the end.

His change of view can also be described in his own words, from his Little Rock speech, May 26th of this year:

> With the world trade disorganized, as it now is, with some of the cotton buying nations taking only one-sixth as much cotton from us as formerly, we must adjust our export price to a level that will be fully competitive in the world market at all times. . . .
> There was no clear evidence last Fall that the 8.3 cent loan would interfere with the flow of cotton into export channels . . . It appears now that if we are to keep the loan, action must be taken to offset its effect on our export market.

The export subsidy, 1½ cents per pound on lint cotton and an equivalent allowance on cotton goods, is being paid on all sales made prior to June 30, 1940. The lint must be exported by July 31, 1940 and the cotton goods by October 31, 1940.

Full effects of the subsidy have not been immediately apparent in spot cotton prices, inasmuch as spot markets both here and abroad have been strong, reflecting the small supply of "free cotton" (due to the impounding of 11,000,000 bales in the loan). The "squeeze" advanced the home markets, leaving room for the foreign markets to hold fairly steady, so that the first effect appeared to be chiefly a rise in the domestic price. As new crop supplies become abundant the depression of the foreign price by the subsidy will naturally be more evident, and the results will be plainer.

Before adoption, the subsidy was vigorously opposed in the cotton trade and in the Senate. The arguments against it were, on principle, that given by Mr. Wallace last Fall, and quoted above; also that taxpayers should not have to pay for selling our cotton to foreign countries cheaper than our own consumers can buy it; and, finally, that retaliations and trade disturbances in unforeseen variety would follow. There is some evidence of the latter even this early. Egypt has removed the former tax on its cotton exports. Other countries will have to sell their cotton at the competitive price set by

the subsidy, and if they consider any measures necessary to enable them to compete they will naturally take them. If all countries meet the lower price the results of the subsidy in increasing our exports may prove disappointing.

Meanwhile the Tariff Commission has the job of imposing quotas, licensing, or in other manner restricting imports, including reimports, of cotton, waste, and piece goods, which otherwise would be attracted by the higher domestic price; and the testimony at the hearings has shown the conflicting interests involved.

Lessons From the Wheat Experience

Those who are struggling with the cotton problem may look to the experience with wheat for guidance. Attempts to regulate wheat exports or acreage through international agreement have been futile, although they date back as far as 1933. The latest parleys were called as a result of the reappearance of the United States as an exporter during the last two years, and the record world crop of 4,571,000,000 bushels in 1938-39. The call for an international conference was made last Fall through the International Wheat Advisory Committee in London, to discuss a minimum price for wheat, apportionment of the world free market for wheat, and abolition of subsidies. This conference has been meeting recently in London, attended by the four leading exporters, the United States, Canada, Argentina and Australia; but it was dissolved on Aug. 29th. The problem of agreeing upon what should be the fair share of each in the export market has proved unsolvable.

Meanwhile the prospect of another large crop and the record breaking world carryover on July 1, 1939, dropped the Liverpool price of wheat lately to the lowest in some three hundred years. The cost of wheat export schemes has risen as the difference between the world and domestic prices widened. It has been estimated that the four countries named above spent something like $125,000,000 in various wheat subsidy measures during the 1938-39 season to export some 489,000,000 bushels, not counting soil conservation and parity payments in the United States.

Although the major exporting countries agreed as early as 1933 that some action should be taken, in practice they have done little to prevent supply and demand from getting out of balance in the world market. Each being anxious to maintain its share of the world market as a means of supporting the wheat growers at home, they have gradually extended control over marketing and prices, rather than allowing economic forces to correct the overproduction. The experience of the losses and the ineffectiveness of the Canadian wheat pools and the Farm Board has been neglected, except for the application of the soil conservation programs in this country. In Argentina a Grain Regulating Board was established as early as 1933 with power to purchase wheat at fixed prices. In Australia, bounties and direct grants to wheat producers date to 1931 and a permanent wheat stabilization scheme is now under discussion. The Canadian Wheat Board, established in 1935, assures the farmers a guaranteed price and directs export sales of wheat surpluses. In the United States four short crops from 1933 to 1936 allowed wheat to stand on its own feet, but the big crop of 1937-38 brought the Government loans and export subsidy of 1938, being continued this season. The average subsidy has been about 27 cents per bushel on 93,750,000 bushels exported during the 1938-39 crop year.

On the supply side the costly export subsidy measures stimulated wheat growing, and the acreage in exporting countries has increased during the last decade by about 20,000,000 acres, to a total of 200,000,000. Meanwhile importing countries have not only maintained their wheat areas, but have secured generally better yields. The subsidies, monopolies, fixed prices, milling regulations and other devices which they have adopted in their quest for self-sufficiency have kept prices to consumers artificially high, and checked the growth of consumption which would have helped to balance the situation. As a result normal yearly import requirements have been reduced by 200 to 300 million bushels since 1929.

The lesson of this experience is that the efforts of each country to support its own wheat growers have prevented the solution of the general problem, while efforts to deal with it through international collaboration have been ineffective because the countries disagreed as to what sacrifices each should make. Each began subsidizing wheat on the theory that the emergency was temporary, and that production must be supported until the general situation became normal, but the situation cannot become normal while production is excessive. The action of governments in subsidizing exports, in competition with each other, have prevented any real adjustment of supply and demand. The prosperity of agriculture, and of every other branch of the economic system, depends in the long run upon orderly and mutually-supporting relations between itself and the other branches or parts. Secretary Wallace's insistence that subsidies must be temporary, and that the final answer must be sought elsewhere, is an acceptance of this truth.

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